# Uncertainty over the future of carbon trading

Phase One of the EU Emissions Trading Scheme (ETS) has helped reduce GHG emissions. Cap and trading is the right way forward but rather than be free $CO_2$ allowances should carry a cost or be auctioned. Phase Two of ETS could see a firmer market and a price of around €25 per tonne would be sufficient to prompt a significant investment in low carbon technologies. These are some of the main conclusions of Moffatt Associates latest European Energy Trends Survey.

## Market reaction to Phase One

The future of carbon trading in Europe, has been the focus of much media attention over the last few months. Under the EU Emissions Trading Scheme (ETS), 12,000 installations in the power generation and particular industrial sectors in the EU are able to buy and sell permits to emit carbon dioxide, covering about 40% of the EU's total emissions.

National Allocation Plans (NAPs) for the first phase of the ETS from 2005-2007 set an overall emissions cap for each country and the allowances for each sector and individual installation covered by the Emissions Trading Directive 2003/87/EC.

Carbon prices in 2005 were generally higher and more volatile than had been expected prior to the launch of the ETS, but publication in May 2006 of actual carbon emissions in EU member states in 2005 revealed a surplus of allowances, with only seven member states reported to have emitted more $CO_2$ than they were allocated in 2005.

This result appeared to confirm the suspicion that most governments had been over-generous in their allocation to industry, or alternatively that industry itself had been over-optimistic about its potential for growth. The announcement on emissions triggered a collapse in carbon prices from about €30 per tonne to below €10, but prices then recovered and have begun to stabilise at around €14 per tonne.

## Scepticism about viability

This price collapse raised doubts in some quarters about the effectiveness of the ETS system, not least whether it would be capable of fulfilling its objectives of reducing carbon emissions and encouraging investment away from polluting sources towards low carbon technologies.

There has been widespread concern that some firms have been able to make windfall profits because of an

over-allocation of allowances, and allocations in the second phase of the scheme, which runs from 2008 to 2012, are expected to be much tighter. NAPs for the second phase should have been submitted by the end of June 2006. However, at the time of writing, only 14 of the 25 EU member states had submitted their plans to the European Commission and only Estonia had actually submitted its plan by the 30TH June deadline.

Belgium, France, Greece, Latvia, Malta, Slovakia, Sweden and the UK have submitted NAPs in the last six weeks, joining Germany, Estonia, Ireland, Lithuania, Poland and Luxembourg, who had all submitted by mid July. The Commission has three months in which to review the new NAPs, but only after it has received all the information that it requires, and it can demand changes if necessary.

The Commission has adopted a relatively moderate tone with those who have failed to meet the deadline for submitting NAPs, whilst warning that they will take action if the NAPs fail to arrive in the next few months.

However, both members of the European Parliament and representatives of EFET (the European Federation of Energy Traders) have expressed deep concern over the delay in NAP submissions. EFET has declared that this could have a negative impact on the liquidity of the forward market for EU allowances over the Phase Two 2008-2012 period. It could also lead to insufficiently clear long-term price signals for investors and undermine the development of low carbon technologies.

## Market expectations

After 18 months the ETS scheme is still relatively new but there has at least been some time to accumulate experience on how the system is working in practice. On the plus side, trading volumes are on the rise, with a total of 350 million tonnes of allowances traded during the first year of the scheme's operation, worth a total of around €9 billion. The market is expected to continue to grow significantly, with predictions that it will more than double in 2006.

However, questions remain concerning grandfathering, how to deal with ▶

new entrants and the allocation method for allowances, as well as whether the scheme should be extended to cover other sectors. Large energy users in Europe have also complained of the excessive pass-through of carbon costs to consumers by electricity companies, which they claim is a major factor in the huge hike in power prices in recent months.

Looking specifically at the results of our survey **(see Table A below – Summary of Responses)**, many members of our panel agreed that Phase One of the ETS had reduced the EU's greenhouse gas emissions, while some also felt that it had established a viable market mechanism and had reflected underlying values of emissions allowances. However there were varying degrees of enthusiasm for these statements, with some respondents believing that the ETS had failed on some or all of these counts. The consensus is that the Emissions Trading Scheme is an immature market, and that this immaturity has led to problems of transparency and lack of information.

Several panel members blamed politicians for impeding the success of the scheme in Phase One. Political interference was believed to be responsible for the over-allocation of emission allowances, a prime contributory factor in what some see as the relative failure of the scheme since it began in January 2005.

## Table A – Summary of Survey Responses

| Percentages | Agree | Disagree | Don't Know |
|---|---|---|---|
| To contain energy costs and help industry Governments always tend to be over-generous in their national allocation of allowances? | 83 | 17 | 0 |
| The current price of allowances is far too low to have any impact on decisions to invest in low carbon technologies? | 22 | 74 | 4 |
| Offset credits (i.e. Certified Emissions Reductions from CDM projects outside the EU) are unlikely to emerge on any significant scale? | 26 | 65 | 9 |
| $CO_2$ allowances should not be allocated freely but should carry a cost or be auctioned? | 74 | 22 | 4 |
| Phase Two of ETS will be tougher and could lead to a price of at least 40 euros per tonne for 2008 delivery? | 40 | 40 | 20 |
| Phase Two will not work because long term planning is essential and nobody knows what's going to happen after 2012? | 27 | 60 | 13 |
| To reduce $CO_2$ the EU would be better off creating more effective gas market competition to reduce the cost of gas fired generation? | 50 | 41 | 9 |

Other reasons put forward by our panel for a certain lack of success in the scheme were industry sectors coming late to market, unsolved political issues such as banking in France and Poland, and regulatory uncertainty. Lack of information was also cited by several of our panel members as a key reason why the success of the ETS may have been impeded.

There was little consensus amongst our respondents concerning what price of $CO_2$ would be necessary to force a significant investment in low carbon technology. Answers varied from €10-€40 per tonne, although the majority opted for a price mid-way between the two.

There were also varying responses concerning whether cap and trade is the right way in which to achieve a major reduction in $CO_2$ emissions. Many agreed that it was the correct approach, since market-based systems were the best way to allocate resources, but some panel members also believed that governments should be more involved by giving incentives to cut emissions and by providing more education on the issue.

There was a difference of opinion relating to how climate change should be managed after the Kyoto Agreement expires in 2012. Some believed that an extension of the current system would be the best way forward, incorporating a more international system and in particular the inclusion of the United States. Others felt that better management of the system was key, with stricter rules on allocation to prevent the over-allocation that has caused so many problems this time around, as well as tighter monitoring. It is also interesting to note that half of our survey respondents agreed that to reduce $CO_2$ the EU would be better of creating more effective gas market competition to reduce the cost of low $CO_2$ gas-fired generation.

### The Commission review

The Commission is currently undertaking a review of the ETS, including issues such as the harmonisation and extension of the scope of the directive, possibly to include more sectors and additional greenhouse gases, more robust compliance and enforcement of the rules, as well as linking trading schemes in third countries and the increased involvement of developing countries. Auctioning is under consideration as a way to counter windfall profits, and environmental groups believe that this would establish a better market price. According to the EU Environment Commissioner, Stavros Dimas, a stakeholder group will be appointed to "intensify" the review later this year. The planned International Transaction Log (ITL), which will check transaction validity and which should began operating from

November 2006, should help to improve market function and transparency.

The fact that there are actual data for carbon emission reductions from the first year of the scheme should make it slightly easier to set targets for the second phase. Phase Two of the ETS will be crucial, but as yet no-one knows how tough it will be, and it is difficult to predict the price of carbon in the longer-term. The Commission is not expected to give its initial assessment on the NAPs it has received until mid-October at the earliest, but it is expected that the Commission will decide to cut emissions allowances in at least some of the plans. The Commission is seeking emission cuts of about 6% for each member state, in order to ensure that they are in line with their Kyoto Protocol commitments to keep emissions at 1990 levels by 2012.

## Uncertain future

Over the next few weeks there are likely to be tough negotiations between the member states and the Commission as it seeks to limit the allocation of allowances, and the result of these negotiations will have a profound effect on how prices will move during Phase Two. Until the second phase NAPs are resolved, the market will continue to be subject to uncertainty and this is expected to translate into price volatility. Although not perfect, the trading market has at least been operational and has provided some price signals, but the influence of national governments and discussions on their Phase Two NAPs will be the main driving force in developments in the market in the near future.

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